

# QUARTERLY REPORT

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## OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan  
*County Executive*

Bruce Romer  
*Chief Administrative Officer*

August 20, 2004

### Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended June 30, 2004. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

### History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 5,571 active members and 4,486 retirees participating in the ERS as of June 30, 2004.

### Performance Results

The total return achieved by the ERS assets for the quarter was a loss of .31% compared to the benchmark index loss of .22%. For the one year period ending June 30, the ERS' gross return (before fees) was 17.16%, nearly 150 bpts. above the benchmark return of 15.66%. The strong one-year return places the ERS' performance in the top 17 percent of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. The outperformance continued through July 31 with the one-year return over 100 basis points above the benchmark index. The asset allocation at June 30, 2004 was: Domestic Equities 51.2%, International Equities 16.6%, Fixed Income 26.5%, TIPS 4.7%, Alternative Investments .3%, Cash .4% and Real Estate .2%.

### Capital Markets and Economic Conditions

During the quarter, investors focused on inflation due to the continued strengthening of the US economy, strong employment data, and high oil prices. Stocks were helped and bonds were hurt by the long-awaited news that jobs were being created at a healthy pace. Other data indicated strength across many economic sectors and surveys reflected companies were regaining pricing power which resulted in a spike in inflation worries. The Federal Reserve began its much anticipated monetary tightening on June 30, raising the Federal Funds rate from its 46-year low by 25 basis points, to 1.25%. The Fed suggested that future rate increases would be gradual in nature, absent an unexpected surge in inflation or domestic growth.

U.S. stocks ended the quarter with positive results, recording a fifth consecutive quarterly gain, driven by strong

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corporate earnings reports. The broad market indices represented by the S&P 500 and Russell 3000, were up 1.7% and 1.3% for the quarter. After gaining nearly 10% during the last quarter, stocks within the emerging markets sector recorded a combined loss of just over 9% during the June quarter. Market declines were attributed to the prospects of higher U.S. interest rates and signs of a slowdown in certain areas of China's economy. Brazil was the market most affected, down nearly 13%, due to its large external debt and growing material exports to China.

During the second quarter of 2004, investors preferred large capitalization growth stocks to small company stocks, reversing the trend of the last few quarters. An increase in interest rates, in conjunction with the recent out-performance of real estate securities relative to other market sectors, caused the REIT sector to fall 5.4% for the quarter. Weakness was also felt in the financial sector as investors perceived the earnings of many financial companies to be vulnerable to rising interest rates. The best returns came from the energy and industrials sectors, with energy companies helped by sustained high oil prices. Our combined domestic equity performance was 1.35% for the quarter inline with the 1.33% return of the Russell 3000 benchmark index. Internationally, the EAFE Index was up just .2% for the quarter due to the strengthening of the US dollar against the yen, euro and sterling. The combined international equity performance of the System was a loss of 1.89% reflecting the strong declines in the System's investments in emerging markets.

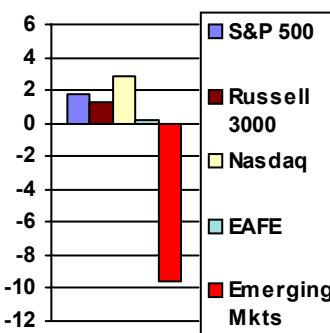
Within the fixed income sector, government bonds posted negative returns as yields in most markets rose in response to increasing inflationary pressures. Shorter maturity US Treasuries sold off briskly, resulting in substantial flattening of the yield curve. The 10-year Treasury yield, which began the quarter at 3.8% closed the quarter at 4.6%. Our combined fixed income return for the quarter was a loss of 1.98% compared to the 2.08% loss recorded by the benchmark index. ERS investments in Treasury Inflation Protection Securities (TIPS) recorded a loss of 2.69% at quarter end outperforming the TIPS benchmark by over 40 basis points.

## Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending June 30, 2004 and fiscal year-to-date.

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**Index Returns  
QTR-June 2004**



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**Employees' Retirement System  
Contributions and Investment Income  
(millions)**

	<u>Qtr 6/30/04</u>	<u>Fiscal YTD</u>
Employer Contributions	\$ 15.4	\$ 61.9
Member Contributions	3.7	14.8
Net Investment Income(Loss)	<u>(6.5)</u>	<u>287.0</u>
	\$ 12.6	\$ 363.7

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## **Deductions**

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, administrative expenses and other costs.

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### **Employees' Retirement System**

#### **Deductions by Type**

(millions)

	<b>QTR 6/30/04</b>	<b>Fiscal YTD</b>
Benefits	\$ 27.2	\$ 111.5
Refunds	.4	.9
Administrative Expenses	.5	2.2
	<hr/> <u>\$ 28.1</u>	<hr/> <u>\$ 114.6</u>

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## **Outlook**

Market sentiment during the next few quarters will be focused on how much and how fast the Federal Reserve will raise short-term interest rates. At quarter end, financial markets had priced in an increase of 125 basis points in the Fed Funds target rate to end 2004 at 2.25%. The Fed has been actively communicating its intention to go slow, seeking to validate rather than to preempt yield movements, making a shift toward an aggressive anti-inflation posture unlikely near term. Consensus forecasts are that moderate growth and easing seasonal price pressures over the second half of 2004 will lend support to the Fed's gradualist approach.

## **Major Initiatives**

The Board approved changes to the allocation of the investments within the fixed income sector, including: lowering the sector allocation from 30% to 25%, increasing the allocation from 5% to 10% to Treasury Inflation Protection Securities (TIPS) and expanding the mandate for the TIPS sector from domestic to global.

In addition, the Board's Comprehensive Annual Financial Report for June 30, 2003 was awarded the Government Finance Officers Association's Certificate of Achievement of Excellence in Financial Reporting.

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## EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS

June 30, 2004

### Assets

Equity in County's pooled cash and investments	<u>\$ 534,533</u>
Investments	
Northern Trust	1,964,208,127
Aetna	9,241,157
Fidelity - Elected Officials Plan	<u>580,139</u>
Total investments	1,974,029,423
Contributions receivable	3,772,644
Fixed assets, at cost:	
Office equipment	111,375
Less: accumulated depreciation	<u>111,375</u>
Net fixed assets	<u>-</u>
Total assets	1,978,336,600

### Liabilities

Benefits payable and other liabilities	<u>2,721,601</u>
<b>Net assets held in trust for pension benefits</b>	<b><u>\$1,975,614,999</u></b>

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**EMPLOYEES' RETIREMENT SYSTEM  
STATEMENTS OF CHANGES IN PLAN NET ASSETS**  
June 30, 2004

	<b>Quarter</b>	<b>Fiscal YTD</b>
<b>Additions</b>		
Contributions		
Employer	\$15,405,367	\$ 61,912,445
Members	<u>3,680,577</u>	<u>14,773,102</u>
Total contributions	<u>19,085,944</u>	<u>76,685,547</u>
Investment income(Loss)	( 4,795,920 )	293,573,118
Less investment expenses	<u>1,658,783</u>	<u>6,570,414</u>
Net investment income	( <u>6,454,703</u> )	<u>287,002,704</u>
Total additions	<u>12,631,241</u>	<u>363,688,251</u>
<b>Deductions</b>		
Retiree benefits	20,815,171	87,013,171
Disability benefits	5,032,000	19,491,388
Survivor benefits	1,308,000	5,031,935
Refunds	435,546	905,590
Administrative expenses	<u>500,133</u>	<u>2,174,447</u>
Total deductions	<u>28,090,850</u>	<u>114,616,531</u>
<b>Net increase (decrease)</b>	<u>( 15,459,609 )</u>	<u>249,071,720</u>
<b>Net assets held in trust for pension benefits</b>		
Beginning of period	<u>1,991,074,608</u>	<u>1,726,543,279</u>
<b>End of period</b>	<u><b>\$1,975,614,999</b></u>	<u><b>\$1,975,614,999</b></u>